BERNSTEIN RESEARCH

Memorandum

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TO: Sales and Trading
FROM: Gary Black
DATE: April 26, 1993
SUBJECT: Philip Morris: Marlboro Strategy and Competitive Response Becoming Clearer.

	4/23 Price	YTD Perf.	EPS 1992E	EPS 1993E	EPS 1994E	P/E 1993E	P/E 1994E	93-97E C.G.R.	Curr. Yield
MO	$48	-38	$5.45	$4.75	$5.10	10.1	9.4	12	5.4%
SPX	439	+1	23.85	25.50	28.25	15.8	15.6	7	2.8

HIGHLIGHTS

We believe the battle in domestic tobacco will proceed as follows:

1. Initial Marlboro price promotion will begin in mid-May and run through end-of-June. Flexibility inherent in using coupons (rather than list price reductions) allows Philip Morris to modify the program if results disappoint or if competitive conditions change.

2. Our trade sources indicate that the promotion involves retail buy-downs (instant coupons affixed at retail) that will be $.30, $.40, and $.50 per pack, depending on the state excise tax level (in New York, the coupons will likely be $.50).

3. Philip Morris' competition will probably match the Marlboro deal by shipping pre-couponed premium product directly to distributors, who would pass on the savings to retailers. The Marlboro plan may bypass distributors.

4. Results from the Marlboro Portland test market indicate that once the Marlboro coupons are removed, market share returns to its pre-coupon levels.

5. Pricing in the deep-discount segment could come under further pressure; dead nets (list price less allowances) remain about $1.25/thousand below the level following the $2.50/thousand price increase taken on the deep-discounts in mid-March.

INVESTMENT CONCLUSION

1. Investment Rating: Market-perform. Our outlook for Philip Morris remains mixed: Near-term, we could see further earnings revisions risk, reflecting the twin uncertainties of the domestic cigarette price war and increased excise taxes. Longer term, the stock looks cheap: the current price is discounting less than 5% earnings growth; we are projecting 12% earnings growth post-1994. We could become more bullish if we saw some sign that Philip Morris can back off from this aggressive program to stabilize domestic market share.

OTHER DETAILS

1. The initial Marlboro promotion is expected to kick off the week of 5/24 and run for about 5-6 weeks. At the end of this period, Philip Morris will evaluate the results, and make a decision to repeat or modify the program.

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2. As expected, the program is likely to involve heavy use of retail buydowns (instant coupons affixed at retail). Coupons will be $.30, $.40, and $.50/pack, depending on state excise tax levels (higher tax states will have higher value coupons).

3. Philip Morris' objective is to get Marlboro's dead net (retail price less coupon) well below $2/pack, so that the retail price gap between Marlboro and the deep-discount brands appears smaller. The current price differential is about $2.10 vs. $1.35; a $.40/pack coupon puts this gap at $1.70 vs. $1.35, making both "a dollar and some change."

4. The Marlboro promotion is nothing new; other premium brands have for months been using buy-downs selectively as a way to keep existing smokers from straying from their brands. What's different is the scope of this promotion, which could cover 80% of all Marlboro volume. Although positioned as a price cut, this action is really a promotion that runs for a finite period of time. If Philip Morris deems the program to be not effective (or entirely effective, and therefore no longer necessary), it can modify or not repeat the promotion.

5. Some distributors seem to be unhappy with the Marlboro program, since Philip Morris is apparently bypassing the distributors and going directly to the retailers to ensure that savings are passed through. Many believe that Philip Morris is selectively choosing retailers who will receive the couponed product. This could hurt Philip Morris in the long-run in its efforts to gain additional distribution and share for its deep discount brands, which remain very trade-driven.

6. Philip Morris' competition will likely match the Marlboro buydowns by offering its largest premium brand with coupons already affixed (same coupon levels as Marlboro). Instead of bypassing the distributor, however, competition's premium brand deal will probably involve off-invoice allowances to the distributors, supplemented with a $.10/carton handling discount. Competition has also apparently announced a major initiative on its fastest growing premium brand, which is essentially a buy-one-get-one-free promotion.

7. In the Portland test market, Marlboro averaged a 20% share during the four-month period preceding the test. During the four-week January test market, Marlboro's share increased to 24%, although it is unclear whether this gain came from other premium brands (most which were not matching the Marlboro offer) or from deep discount brands. After the test ended, the coupons were removed, and Marlboro's share returned to 20%.

8. The danger in this strategy is that, over an extended period (much longer than a four-week test), Philip Morris may be training all Marlboro smokers to "wait for a deal" before purchasing. An infrequent, carefully-pulsed, selective promotional strategy can help sustain higher market share long-term; a broad, continuous every-day strategy of pricing down Marlboro (or any other premium product) can cause otherwise loyal smokers to expect a deal. If a deal doesn't appear, these loyal users could feel they are not getting a good value and defect to comparable brands offered at the Marlboro "deal" price.

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9. Silence by Philip Morris' competition following two weeks of speculation would indicate that they will respond by defending their brands across all segments if necessary. The statement by competition's management that "we've gained a lot of ground in the market ... and we aren't going to give that ground back" is particularly telling, since much of the competition's growth has come entirely from volume gains in the deep-discount segment. Competition's decision to not reduce allowances in the deep discount segment since Marlboro Friday could be taken as a sign that they may stand and fight rather than allow Philip Morris to take market share. We should get some insight as to the reasoning behind the competition's strategy next week.

10. We could see further disruption in deep-discount pricing, which could prevent Marlboro from narrowing the spread between Marlboro and the deep-discount brands.

- In mid-March, Philip Morris announced a $2.50/thousand increase in deep-discount prices. Concurrently, Philip Morris was offering a "buy 10, get one free" (10% deal) carton allowance on its Basic deep-discount brand.
- Competition matched the $2.50/thousand increase and, one week later, responded to the Basic promotion by increasing allowances by $3.75/thousand on their deep discount brand (also 10% deal).
- American Brands never followed the $2.50/thousand price increase; AMB has since matched the Basic/Monarch deals.

Deep-discount dead nets are now $1.25/thousand below the mid-March levels, and could be pressured further if Brown & WIlliamson became more aggressive in its efforts to turn around its major deep discount brand (GPC-approved), which is now losing share to both MO's and competition's discount brands.

Our Outlook

1. We are not convinced that Philip Morris' plan to reduce Marlboro retail prices by $.40/pack will result in increased share. While we agree that Philip Morris had to do something to stem Marlboro's share erosion, this pricing strategy, while flexible, may not allow the retail price gap between Marlboro and the deep discounts to narrow sufficiently:

   i. We expect Philip Morris' competitors to move to protect their own premium and discount share positions with aggressive promotions of their own.

   ii. We project an ever-widening base of convenience stores developing and promoting their own exclusive store brands as low-margin loss leaders to bring in traffic.

   iii. Increased couponing on Marlboro and other premium brands will likely lead to a reduction in mid-priced brand dead nets to the levels of the deep-discount brands, effectively causing the two segments to merge at the deep-discount price. With nowhere to go and in danger of

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losing permanent shelf space, new disruption in deep-discount brand prices (including the possible emergence of a new lower-price tier) is possible.

2. Collectively, we could see a ratcheting down of the entire industry pricing structure. This could put Marlboro back in the same relative price position at which it started pre-"Marlboro Friday," but earning 30% (rather than 50%) margins.

3. The inherent flexibility and finite nature of the Marlboro promotional program may allow Philip Morris to modify or back away from this high-risk strategy if the strategy fails or if competitive conditions change. We should get first indications as to how the program is working when May-June Nielsen volume and share data come out in mid-August. Given the market's interpretation that this "price cut" is somewhat permanent, a Philip Morris move to modify or scale back this $2 billion plan could lead us to become more bullish.

4. We maintain that the price war could ultimately lead Marlboro to introduce a shorter (70 millimeter) Marlboro Express-type fighter brand that could be priced initially at $.50/pack less than regular Marlboro.

    i. This would allow Marlboro to split its brand franchise into two segments -- those willing to pay full price and those who aren't. The Marlboro fighter brand net price could move up and down in tandem with deep discount dead nets. The premium brand Marlboro could continue to be sold at full price.

    ii. The key marketing challenge would be to position the mid-priced Marlboro not as a cheaper version of the full-priced brand, but rather, as offering some unique and positive benefit (e.g. a cigarette for people on the run, for those who want a quick smoke, etc.).

    iii. The negative aspect of a Marlboro Express-type product is its inflexibility -- once introduced, Philip Morris may not be able to withdraw the cheaper Marlboro product (as it can with couponed-product) if cannibalization (from premium Marlboro) got too high, or if competitive conditions improved.

    iv. If Marlboro moved first, we would expect many of Philip Morris' competitors to introduce fighter-brand versions of their best-selling premium brands. In the end, many of the discount brands would likely disappear.

    v. Philip Morris USA profitability with a Marlboro fighter-brand product would not likely reach pre-"Marlboro Friday" levels; this alternate strategy could, however, deliver higher profits than Marlboro's current retail buydown strategy. Assuming that 50% of current Marlboro users are price insensitive, and the other 50% need a deal, the average "price cut" (assuming a $.50/pack discount on Marlboro Express) would be $.25/pack. This compares to the average $.40/pack announced by Marlboro on April 2. Longer-term profitability differences could be even greater, because full-price Marlboro would likely retain pricing flexibility going forward.

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